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No. 79-725

In the Supreme Court of the United States

OCTOBER TERM, 1979

THE STATE OF MAINE PUBLIC UTILITIES COMMISSION,
PETITIONER

v.

CENTRAL MAINE POWER COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME JUDICIAL COURT OF THE STATE OF MAINE

MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

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MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

This memorandum is filed pursuant to the Court's invitation of February 19, 1980.

QUESTION PRESENTED

Whether the decision below held that the ratemaking order of the State of Maine Public Utilities Commission would have jeopardized respondent's eligibility for accelerated depreciation for federal income

tax purposes under Section 167(*l*) of the Internal Revenue Code of 1954 (26 U.S.C.).

STATEMENT

Respondent is a public utility that has elected for federal income tax purposes to adopt the normalized method of accounting under Section 167(*l*) of the Internal Revenue Code of 1954 (Pet. App. A 45). Under that method of accounting, respondent may compute certain of its depreciation deductions under accelerated methods for tax purposes only if those same depreciation expenses are computed under straight-line methods for ratemaking purposes. Adjustments must be made to a deferred tax reserve account to reflect the differences in the two depreciation computations. See Section 167(*l*)(3)(G).

On January 16, 1978, respondent filed a proposed rate schedule with petitioner, the Maine Public Utilities Commission. Respondent's rate schedule sought approximately $25 million in additional revenues (Pet. App. A 15). After extensive hearings, the Commission adopted a rate schedule which granted respondent approximately a $15.5 million rate increase (Pet. App. A 17). In setting these rates, the Commission determined that respondent should not be recompensed by the ratepayers for all the depreciation expenses it had claimed. Rather, the Commission concluded that depreciation claimed on property financed by respondent's reserve for deferred taxes was not a cost that should be borne by the ratepayers.[1] The Commission premised this adjustment on its view that the reserve constituted capital that respondent's investors had not supplied. As the Commission viewed the matter, neither respondent nor its investors were entitled to recover that capital in the form of depreciation, but the recovery should instead be secured for respondent's ratepayers (Pet. App. A 37-39; Pet. App. B 141-144).

In November 1978, pursuant to the provisions of Me. Rev. Stat. Ann., tit. 35, §§ 303, 305 (1964), respondent sought review of the Commission's decree in the Supreme Judicial Court of the State of Maine (Pet. App. A 17-18). That court upheld respondent with respect to the disallowed depreciation expenses and remanded the case to the Commission for appropriate adjustments. From its examination of the terms of Section 167(*l*) of the Internal Revenue Code of 1954, the accompanying legislative history and Treasury Regulations, and the pertinent private letter rulings of the Internal Revenue Service, the court concluded that the Commission's action departed

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[1] For the test year 1977, respondent's deferred tax reserve was $19,504,000. See Section 167 (*l*)(3)(G). Because the Commission was unable to trace respondent's assets to their respective capital sources, the Commission assumed that a pro rata portion of each depreciable asset had been financed out of this reserve. Accordingly, the Commission multiplied the amount of the reserve by respondent's composite depreciation rate (3.32%) to determine the amount of depreciation attributable to property financed by the reserve. The net effect of this determination was to lower respondent's required revenue needs by approximately $600,000 (Pet. App. A 37-38, 47-48; Pet. App. B 141, 143-144).

from the Internal Revenue Code's requirement of normalization and thereby jeopardized respondent's eligibility to claim accelerated depreciation for federal income tax purposes. In the court's view, the Commission abused the ratemaking discretion conferred upon it by state law in placing respondent in such jeopardy (Pet. App. A 21, 42-56). As the court observed, "A contrary conclusion would ask us to believe that Congress intended the strictures of § 167(*l*) to be merely advisory; that if the State regulatory agencies wished to defy national economic policy they were free to do so" (Pet. App. A 48-49).

DISCUSSION

The decision below correctly held that implementation of the Commission's decision would have jeopardized respondent's eligibility to claim accelerated depreciation for federal tax purposes. Under Maine law, the Commission does not have authority to set rates in such a manner as to "jeopardize" a public utility's right to claim accelerated depreciation for federal income tax purposes. In a similar case, *New England Telephone and Telegraph Co.* v. *Public Utilities*, 390 A. 2d 8, 24 (Me. 1978), the court below had previously held that the Commission had unreasonably exercised its powers and abused the ratemaking discretion conferred upon it when it set rates in such a manner as to create—

> a reasonable likelihood that * * * [a utility] would lose its ability to take accelerated depreciation or, at least be subject to federal action with respect thereto. The effect of the Commission's decree, if sustained by this Court, would be, at least, to place * * * [the utility] in jeopardy of losing its ability to take accelerated depreciation for federal income tax purposes.

In the *New England* case, the Maine court explicitly stated that for state law purposes it was not necessary to determine whether the utility "would lose its right to take accelerated depreciation" if the Commission's rate order were upheld. Rather, the fact that the utility was placed in "jeopardy" of losing that right or might "be subject to federal action with respect thereto" was a sufficient ground upon which to conclude that the Commission's order was beyond the scope of its authority (*ibid.*).

Here, the decision below likewise held that the Commission's rate order would jeopardize respondent's eligibiilty to claim accelerated depreciation or, "at least, [render it] * * * subject to federal action with respect thereto" *New England Telephone and Telegraph Co.* v. *Public Utilities, supra,* 390 A. 2d at 24. See also Pet. App. A 48-49. In so ruling, we submit that the Maine court correctly concluded that the Commission's order would require respondent to violate the conditions under which accelerated depreciation can be claimed for federal tax purposes.

When Congress enacted the normalization requirements of Section 167(*l*), it intended to proscribe certain regulatory practices that effectively passed through to the consumer the full measure of tax sav-

ings that flowed to certain utilities electing to claim accelerated depreciation for federal income tax purposes. See, generally, *FPC* v. *Memphis Light, Gas and Water Division*, 411 U.S. 458 (1973). Congress concluded that the combined effect of accelerated depreciation (leading to higher tax deductions) and flow-through for fixing rates (leading to lower gross revenues and therefore lower taxes) resulted in an unacceptable loss of federal revenues. H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 131-132 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 172-175 (1969).

Thus, in Section 167(*l*) of the Code, Congress provided that utilities such as respondent were entitled to accelerated depreciation for tax purposes only if their rates were set under certain "normalized" methods of accounting. Under the normalized methods, rates would generally have to be set as though the utility had not elected accelerated depreciation. The tax savings arising from accelerated depreciation would then be reflected in a deferred tax reserve account. This method was designed to avoid giving the present customers of a utility the full benefit of the tax deferrals attributable to accelerated depreciation and make the deferred taxes available to the utility for investment.

This is not to say that none of the benefits of accelerated depreciation can be passed on to the ratepayers under normalization. Rather, Congress intended that a small portion of those benefits could be passed on to the ratepayers in the form of lower rates. Accordingly, it explicitly permitted the amount

reflected in the deferred tax reserve (or the public utility property acquired with that amount) to be excluded from the rate base upon which a regulatory agency "computes the company's maximum permitted profits" S. Rep. No. 91-552, *supra*, at 173. See Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.), Section 1.167(*l*)-1(h)(6); see *Pacific Telephone and Telegraph Co.* v. *Public Utilities Commission of California*, hearing denied, No. 23746 (Cal. Sup. Ct. July 13, 1978), cert. denied, 439 U.S. 1052 (1978).[2] But as the Committee Reports

[2] Contrary to petitioner's suggestion (Pet. 11), the decision below does not conflict with *Pacific Telephone and Telegraph Co., supra*, where we filed a brief *amicus curiae* urging review by this Court. There, the Supreme Court of California denied hearing of an appeal from a ruling of the California Public Utilities Commission that its rate-making orders preserved the utilities' eligibility for the investment credit and accelerated depreciation under Sections 46(f) and 167(*l*) of the Internal Revenue Code.

Petitioner argues (Pet. 11) that the decision below conflicts with *Pacific Telephone and Telegraph Co.* insofar as the California Commission's order remains undisturbed while "the Maine Commission's judgment has been reversed." Apart from the differences in the methods of accounting employed by the regulatory commissions in the two cases, the standards of review employed by the state courts in the two cases were entirely different. In *Pacific Telephone and Telegraph Co.*, the California Public Utilities Commission was aware of the Internal Revenue Service's rulings that the Commission's order destroyed the utility's eligibility for accelerated depreciation and the investment credit but declined to join the utility in requesting a remand of the case to the Commission, stating that "the ruling adds nothing new to these proceedings" (Decision No. 88972 (June 13, 1978). The

(H.R. Rep. No. 91-413, *supra;* S. Rep. No. 91-552, *supra*) make clear, no other mechanism for passing the benefits of accelerated depreciation on to the ratepayers was to be sanctioned as consistent with the normalization rules. Indeed, any other such mechanism would run directly counter to the statutory purpose of limiting revenue losses attributable to accelerated depreciation.

Here, the rate order entered by the Commission required respondent to eliminate all amounts attributable to the depreciation of assets financed by the deferred tax reserve from its revenue requirements (Pet. App. B 141-144). Accordingly, depreciation expenses taken into account for ratemaking purposes were reduced by approximately $600,000 and that $600,000 reduction in revenue requirements was directly passed through to the ratepayers. It is therefore clear that the Commission's rate order is contrary to Section 167(*l*) and, if permitted to stand, would have jeopardized respondent's eligibility for accelerated depreciation.

Commission presumably disagreed with the Service's ruling on the merits.

Here, on the other hand, the standard of review employed by the Maine Court was whether the Commission's order "jeopardized" respondent's eligibility for accelerated depreciation. In these circumstances, the court was amply justified in concluding that the Internal Revenue Service rulings demonstrated that the Commission's order would have jeopardized petitioner's eligibility for this federal tax benefit. Thus, in addressing the California decision, the Maine court properly found "More significant * * * the initial I.R.S. reaction to that decision" (Pet. App. A 53).

Contrary to the Commission's argument (Pet. 6), its method of computing rates was not simply a permissible adjustment to respondent's basis of its assets.[3] Rather, this change in the treatment of a material item constituted a departure from the normalization method of accounting for ratemaking purposes. Cf. *Korn Industries, Inc.* v. *United States*, 532 F.2d 1352, 1355 (Ct. Cl. 1976); *Witte* v. *Commissioner*, 513 F.2d 391, 393 (D.C. Cir. 1975); Treasury Regulations on Income Tax, Section 1.446-1(e)(2)(i) (26 C.F.R.).

As the court below recognized (Pet. App. A 55), Congress intended that virtually all the benefits of accelerated depreciation must remain with the utilities and not be passed to the ratepayers. See S. Rep. No. 91-552, *supra*, at 174. The Treasury Regu-

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[3] While the Treasury Regulations permit the use of different depreciation bases for computing costs of services and for federal tax purposes when those differences are attributable to a change in the useful life of the property, a change in the taxpayer's unrecovered cost, or certain other adjustments (Treasury Regulations on Income Tax (1954) Code) Section 1.167(*l*)-1(a)(2) (26 C.F.R.); see S. Rep. No. 91-552, *supra* at 174, the Regulations do not permit the elimination of property financed by the deferred tax reserve from the category of property as to which depreciation expense may be claimed. As the Senate Report states, only differences in depreciation methods that arise from the different conventions applicable to financial and tax accounting (for example, the use of "engineering lives" for financial purposes compared to "guideline lives" for tax purposes) are permissible. S. Rep. No. 91-552, *supra*, at 174. The Commission's "adjustment" does not arise from such differing conventions. Rather, it is designed to return to the ratepayers capital which, as a result of the tax deferral available from accelerated depreciation, the federal government had "loaned" to the utility.

lations make clear that unless the full amount of the tax deferral resulting from use of accelerated depreciation is normalized, a utility will be ineligible to claim accelerated depreciation for federal tax purposes. Treasury Regulations on Income Tax (1954 Code) Section 1.167(*l*)-1(h)(2)(ii), Examples (4) and (5).[4] There can be no doubt that the effect of the Commission's order was to pass on a portion of the tax benefit to the ratepayers. Thus, if the order were implemented, respondent would have forfeited its right to claim accelerated depreciation.[5]

Finally, there is no basis for the Commission's assertion (Pet. 12-14) that eligibility for accelerated depreciation depends solely on the utility's keeping

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[4] Examples (4) and (5) of the cited Regulations make clear that a partial flow-through of the benefits of claiming accelerated depreciation for federal tax purposes is prohibited whether the partial flow-through is the result of normalizing only part of the deferred tax reserve or the result of using normalization accounting with respect to only a part of its public utility property. The present case is very similar to Example 5. In that example, an order of a regulatory body requires the utility to use normalization accounting but only with respect to 50 percent of its property. Because the effect of the order is to flow-through a portion of the tax savings resulting from the use of accelerated depreciation, the utility is deemed to have departed from normalization accounting.

[5] There is presently pending before the House Comm. on Ways and Means a bill that would exempt utilities from the present normalization requirements for accounting periods ending prior to March 1, 1980, if the utility used accounting methods prescribed by order of a state or local government, public service or utility commission similar to the methods employed by the California Public Utilities Commission in *Pacfic Telephone and Telegraph Co., supra.* See H.R. 6806, 96th Cong., 2d Sess. (1980).

its books of account in accordance with Section 167 (*l*) and that regulatory treatment in conflict with the federal tax statute will not alone jeopardize eligibility. Section 167(*l*)(3)(G) specifies that the required methods of accounting be used "for ratemaking purposes." Congress therefore plainly intended that the state regulatory agencies must adhere to normalization requirements if utilities are to maintain eligibility for accelerated depreciation. As the Senate Report explained, in terms that explicitly refute the Commission's contention (No. 91-552, *supra*, at 174):

> The committee amendments provide that the requirement of normalizing is not met by simply normalizing the regulated books of account of the utility if these books of account may be ignored by the regulatory agency in setting rates. Under the committee amendments, while the regulated books of account are to be used as the basic source of information, these books are not to control if the current rates of the utility are set by reference to the flow-through method. This is done because the use of flow-through in setting rates would produce the revenue loss the bill seeks to avert.

CONCLUSION

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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